



PCG 2016/5 frequently asked questions

This page contains answers to frequently asked questions (FAQs) about the application of Practical Compliance Guideline [PCG 2016/5 \(/law/view/document?DocID=COG/PCG20165/NAT/ATO/00001&PiT=99991231235958\)](#) to non-arm's length limited recourse borrowing arrangements (LRBAs).

PCG 2016/5 sets out the 'safe harbour' terms on which self-managed super fund (SMSF) trustees may structure their LRBAs consistent with an arm's length dealing.

PCG 2016/5 FAQs

My SMSF has entered into an LRBA which does not meet the terms of PCG 2016/5 however it does meet the terms of a housing lending rate quoted by a financial institution. Will this result in NALI?

If your SMSF has entered into an LRBA which does not meet all of the 'safe harbour' terms of PCG2016/5, it does not mean that the arrangement is deemed not to be on arm's length terms. Meeting the terms of the PCG simply means that the trustees are assured that the Commissioner will accept that the arrangement with an arm's length dealing.

If your LRBA does not meet the safe harbour terms outlined in the PCG, you need to be able to otherwise demonstrate that the arrangement was entered into and maintained on terms consistent with an arm's length dealing. One example of how you could demonstrate the arm's length nature of the arrangement may be by providing evidence of a loan offer to the SMSF in relation to the particular asset from a financial institution.

Does PCG 2016/5 also apply to unlisted shares or units? Can I rely on the safe harbour terms where I have an LRBA over unlisted units however the underlying assets of the trust are real property?

The safe harbour terms outlined in PCG 2016/5 only apply where the asset being acquired is real property or a collection of stock exchange listed shares or units. Where the asset being acquired is unlisted shares or units, the PCG will not apply regardless of the underlying assets of the entity.

If you have an LRBA over unlisted shares or units, you will need to otherwise demonstrate that the arrangement was entered into and maintained on terms consistent with arm's length dealing.

Can I apply the safe harbours in PCG 2016/5 to assets other than real property or listed units and shares?

The safe harbours provided in PCG 2016/5 only apply to LRBAs that are used to acquire real property or stock exchange listed shares or units. SMSF trustees who use an LRBA to acquire other assets – such as shares in an unlisted company or units in an unlisted unit trust – will need to be able to demonstrate that the arrangement was entered into and maintained on terms consistent with an arm's length dealing when considering the application of the non-arm's length income (NALI) provisions.

One example of how a trustee may demonstrate this is by obtaining evidence that shows their particular arrangement is established and maintained on terms that replicate the terms of a commercial loan that is available to them in the same circumstances. A printout from a bank's website of general loan terms is not sufficient to meet this requirement.

Where, for example, an LRBA is over an asset for which the SMSF could not find a commercial third party lender to provide finance to acquire that asset and so entered into a related party loan, the trustee will be unable to demonstrate that the LRBA has been made on arm's length terms. For the SMSF to be assured that it won't be selected for an income

tax review for the 2014–15 year or earlier years purely because the SMSF entered into an LRBA, the LRBA will need to be brought to an end by 31 January 2017.

Are there any plans to expand the safe harbours in PCG 2016/5 to other assets such as shares in unlisted companies and units in unlisted unit trusts?

The ATO does not have any plans to expand the safe harbours in PCG 2016/5 to include other assets such as unlisted units and shares which vary in nature and differ in the terms under which they may be acquired. The current safe harbours apply to the majority of LRBA's.

Do the safe harbours in PCG 2016/5 apply in relation to shares in a body corporate that provide the shareholder exclusive possession or rights in relation to a specified unit or apartment?

No, as these assets are not real property. However, this does not mean the NALI provisions automatically apply. Trustees will need to demonstrate that their arrangements are consistent with an arm's length dealing. In addition to the terms of the loan being on an arm's length basis, it must be shown that the asset is one that an arm's length party would lend against.

If by the 31 January 2017 deadline a taxpayer has not satisfied PCG 2016/5, will the ATO give taxpayers a further opportunity to rectify the loan arrangement?

Where SMSF trustees have not satisfied all the criteria of the PCG 2016/5, it does not mean that the arrangement will necessarily be deemed to be non-arm's length. This only means that the trustees are unable to be assured that the Commissioner will accept the arrangement to be consistent with an arm's length dealing.

PCG 2016/5 states that we will not select an SMSF for an income tax review for the 2014–15 year or earlier years purely because the SMSF has entered into an LRBA. However, this is conditional on the trustee ensuring that any LRBA that their fund has is on terms consistent with an arm's length dealing by 31 January 2017 or, alternatively, is brought to an end by that date. In addition, payments of principal and interest must be made under the LRBA terms consistent with an arm's length dealing by 31 January 2017.

Following this deadline, if it is considered that the NALI provisions apply to a particular LRBA and no reasonable attempt has been made to bring the arrangement in line with an arm's length dealing, the NALI provisions will apply from the commencement of the arrangement.

If you require advice on LRBA's and the application of the NALI provisions, we encourage you or your adviser to contact us in writing as soon as possible. This correspondence should be sent to:

Australian Taxation Office
PO Box 3100
Penrith NSW 2740

If you still have an LRBA in place to which the NALI provisions apply, we encourage you to contact us by making a voluntary disclosure. We can work with you and your SMSF professional to determine what action may be required to resolve this matter.

To make a voluntary disclosure, complete the [SMSF regulatory contravention disclosure form](#). ([/Forms/SMSF-regulatory-contravention-disclosure/](#)) Include your proposal on how you intend to rectify this issue.

See also:

- [SMSF early engagement and voluntary disclosure service](#) ([/super/self-managed-super-funds/administering-and-reporting/how-we-help-and-regulate-smsfs/smsf-early-engagement-and-voluntary-disclosure-service/](#))

How do we show international interest rates are consistent with an arm's length dealing?

Trustees need to show evidence that the terms of the loan are arm's length. In order to satisfy the Commissioner of the arm's length nature of a particular loan with attributes of those outside PCG 2016/5, the trustees should provide relevant documentation to substantiate the arm's length nature. This may include documentation relating to a bank or commercial

lender's loan offer to the SMSF for comparison with the loan documentation of the related party. This test would apply for both local and international lenders.

Must a charge/mortgage be registered where there is a related party loan?

Similar to the above answer, if trustees wish to take advantage of the safe harbour provisions, they must meet all the terms and conditions set out within PCG 2016/5. This includes registering a charge/mortgage or similar security, even in the case of a related party loan.

If there is not a registered charge/mortgage, trustees will need to provide relevant documentation to substantiate the arm's length nature of the arrangement. This may include documentation relating to a bank or commercial lender's loan offer to the SMSF for comparison with the loan documentation of the related party.

Can refinancing of an existing loan be with a related party lender?

There is no prohibition on the refinancing of an existing loan with a related party lender. However, to ensure that the NALI provisions do not apply, SMSF trustees will need to provide evidence that the refinanced loan is established and maintained on terms consistent with an arm's length dealing; for example, by applying the safe harbour guidelines in PCG 2016/5 if applicable.

Are the interest rates referred to in 'Safe Harbour 1' and 'Safe Harbour 2' in PCG 2016/5 to be applied as nominal annual interest rates or are they to be compounded?

Both 'Safe Harbour 1' and 'Safe Harbour 2' options in PCG 2016/5 require monthly payments of principal and interest. On that basis, interest is required to be calculated monthly on a compounding basis (ie, not on an annual nominal basis).

If I have an LRBA that is not on arm's length terms and the non-arm's length provisions apply, what do I report in my 2016 SMSF annual return?

If at the time of lodgement of its 2016 SMSF annual return, an SMSF trustee has not taken action to ensure any LRBA in their fund is on terms consistent with an arm's length dealing and the required catch-up payments have not been made, the relevant income is NALI and should be reported as such in the SMSF's 2016 annual return.

If you lodge your 2016 SMSF annual return after 31 January 2017 and your LRBA is consistent with the safe harbour terms in PCG 2016/5, including the requirement that all catch-up principal and interest payments have been made, then you don't need to report any relevant income as NALI.

If you lodge your SMSF annual return prior to 31 January 2017 and have not restructured your arrangement, there would need to be an intention to restructure the LRBA and make the required principal and interest payments, for the SMSF not to report NALI. If you subsequently do not take these steps, the 2016 SMSF annual return should be amended to report NALI. SMSF trustees should consider making a voluntary disclosure in these circumstances.

Restructure of the LRBA can occur anytime up to and including 31 January 2017 and the interest rate and other terms (eg loan to market value ratio (LVR) and remaining loan term) should reflect the date the restructure is done. We would consider it best practice for the SMSF to record accrued liabilities for any additional principal and interest payments relating to the 2015–16 year, made after 30 June 2016 and by 31 January 2017, if the fund does not report the relevant income as NALI in the 2016 SMSF annual return.

Are catch up payments of principal and interest required to be made from the beginning of the borrowing arrangement?

In accordance with PCG 2016/5, we will not select an SMSF for an income tax review for the 2014–15 year or earlier years purely because the SMSF has entered into an LRBA. This is conditional on the SMSF trustee ensuring that any LRBA that their fund has is on terms consistent with an arm's length dealing by 31 January 2017, or is brought to an end by that date. For this concession to apply, catch up payments of principal and interest should also be made from 1 July 2015 for those arrangements that are either brought to an end by 31 January 2017 or are on terms consistent with an arm's length dealing by this date.

Do the NALI provisions apply to all of the income generated by the asset or just the non-arm's length portion?

An amount of income either has the character of being NALI or it does not. When an amount of income is NALI, the whole amount is NALI. An amount of income that is characterised as NALI cannot be divided between an amount that is NALI and an amount that is not NALI. The amount of income that is NALI is not only the amount by which an amount of income is greater than the amount that might have been derived if the parties had been dealing at arm's length; it is the whole amount of income derived, including any capital gains (refer to [Taxation Ruling TR 2006/7 \(/law/view/document?docid=txr/tr20067/nat/ato/00001&pit=99991231235958\)](#), paragraphs 10 and 12).

My SMSF borrowed money from a related party to enter into an LRBA that satisfied all the terms in PCG 2016/5. However, due to a downturn in the market, the value of the single acquirable asset has decreased and now the LVR under the arrangement has fallen outside the acceptable range provided by PCG 2016/5. Is my LRBA now subject to the NALI provisions?

For the purposes of applying PCG 2016/5 where there have been market fluctuations, we look at the LVR at the time the loan is taken out. Therefore, it is the market value of the asset at the time the loan is entered into that is important when applying the PCG.

See also:

- [Practical compliance guidelines \(/law/view/document?DocID=COG/PCG20165/NAT/ATO/00001&PiT=99991231235958\)](#)
- [Guidance for SMSFs with non-arm's length LRBAAs \(\[http://lets-talk.ato.gov.au/LRBA_NALI\]\(http://lets-talk.ato.gov.au/LRBA_NALI\)\)](#)

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